



Investment Management Services Taxation

Why is Congress concerned about this issue?

Many investment funds are structured as partnerships in which investors become limited partners and the funds' managers are the general partner. The managers often take a considerable portion of their compensation for managing the funds' investments as a share of the funds' profits using a mechanism called "carried interest." Partnership profits are taxed not to the partnership; instead partners are taxed on allocations of partnership income, and the nature of that income (capital or ordinary) "flows-through" to the partners. As a result, the investment managers are able to have income for performance of services taxed at the 15% capital gains rate. Essentially they are able to pay a lower tax rate on income from their work than other Americans simply because of the structure of their firm.

What does the legislation do?

It clarifies that any income received from a partnership, capital or otherwise, in compensation for services is ordinary income for tax purposes. As a result, the managers of investment partnerships who receive a carried interest as compensation will pay regular income tax rates rather than capital gains rates on that compensation. The capital gains rate will continue to apply to the extent that the managers' income represents a reasonable return on capital they have actually invested in the partnership.

What kinds of investment firms will be affected?

This part of a broad consideration of tax fairness. The principle at work is that compensation for services should be treated as ordinary income and taxed accordingly, regardless of its source. Any investment management firm that takes a share of an investment fund's profits as its compensation (i.e. in the form of carried interest), will be affected. This will apply to any investment management firm without regard to the type of assets, whether they are financial assets or real estate. The test is the form of compensation, not the type of assets the firm is managing, its investment strategy, or the amount of compensation involved.

Would this affect REITs?

To the extent that a Real Estate Investment Trust is receiving income in the form of a carried interest in another real estate partnership, this would affect the character of income received for purposes of determining the character of income distributed to shareholders. The legislation would not affect an entity's ability to qualify as a REIT.

Would this affect publicly traded partnerships?

Yes, if more than 10% of a publicly traded partnership's income comes from a carried interest covered by the legislation, they will be taxed as a corporation.

What is the effective date of the legislation?

This legislation is designed to create a structure under which this income should be taxed. Decisions on the effective date will be made as part of the legislative process.